

other than that of providing transportation service between points in the United States and points outside the United States, the costs and expenses, including taxes, properly apportioned or allocated to such other business shall be excluded both from the deductions and from the apportionment process prescribed in paragraph (c) of this section; but, for the purpose of determining taxable income, a ratable part of any general expenses, losses, or deductions, which cannot definitely be allocated to some item or class of gross income, may be deducted from the gross income from sources within the United States after the amount of such gross income has been determined. Such ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income. See paragraph (f)(3) of this section.

(3) *Personal exemptions and special deductions.* The deductions for the personal exemptions, and the special deductions described in paragraph (c) of § 1.861-8, shall not be taken into account for purposes of paragraph (c) of this section.

(e) *Property used while within the United States—(1) General.* The value of the property used shall be determined upon the basis of cost less depreciation. Eight percent may ordinarily be taken as a reasonable rate of return to apply to such property. The property taken shall be the average property employed in the transportation service between points in the United States and points outside the United States during the taxable year.

(2) *Average property.* For ships, the average shall be determined upon a daily basis for each ship, and the amount to be apportioned for each ship as assets employed within the United States shall be computed upon the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of days the ship was in service during the taxable period. For other assets employed in the transportation business, the average of the assets at the beginning and end of the taxable period ordinarily may be taken, but if the average so obtained does not, by reason of material changes during the

taxable year, fairly represent the average for such year either for the assets employed in the transportation business in the United States or in total, the average must be determined upon a monthly or daily basis.

(3) *Current assets.* Current assets shall be decreased by current liabilities and allocated to services between the United States and foreign countries and to other services. The part allocated to services between the United States and foreign countries shall be based on the proportion which the gross receipts from such services bear to the gross receipts from all services. The amount so allocated to services between the United States and foreign countries shall be further allocated to services rendered within the United States and to services rendered without the United States. The portion allocable to services rendered within the United States shall be based on the proportion which the expenses incurred within the territorial limits of the United States bear to the total expenses incurred in services between the United States and foreign countries.

(f) *Taxable income—(1) General.* In computing taxable income from sources within the United States there shall be allowed as deductions from the gross income from such sources, determined in accordance with paragraph (b) of this section, (i) the expenses of the transportation business carried on within the United States (as determined under paragraphs (c) and (d) of this section) and (ii) the expenses and deductions determined in accordance with this paragraph.

(2) *Interest and taxes.* Interest and income, war-profits, and excess profits taxes shall be excluded from the apportionment process, as indicated in paragraph (d) of this section; but, for the purpose of computing taxable income there may be deducted from the gross income from sources within the United States, after the amount of such gross income has been determined, a ratable part of all interest deductible under section 163 and of all income, war-profits, and excess profits taxes deductible under section 164, paid or accrued in respect of the business of transportation service between points in the United States and points outside the United

States. The ratable part shall ordinarily be based upon the ratio of gross income from sources within the United States to the total gross income, from such transportation service.

(3) *General expenses.* General expenses, losses, or deductions shall be deducted under this paragraph to the extent indicated in paragraph (d)(2) of this section.

(4) *Personal exemptions.* The deductions for the personal exemptions shall be allowed under this paragraph to the same extent as provided by paragraph (b) of § 1.861-8.

(5) *Special deductions.* The special deductions allowed in the case of a corporation by sections 241, 922, and 941 shall be allowed under this paragraph to the same extent as provided by paragraph (c) of § 1.861-8.

(g) *Allocation based on books of account.* Application for permission to base the return upon the taxpayer's books of account will be considered by the district director (or, if applicable, the Director of International Operations) in the case of any taxpayer subject to this section, who, in good faith and unaffected by considerations of tax liability, regularly employs in his books of account a detailed allocation of receipts and expenditures which more clearly reflects the income derived from sources within the United States than does the process prescribed by paragraphs (b) to (f), inclusive, of this section.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8687, 61 FR 60550, Nov. 29, 1996]

#### § 1.863-6 Income from sources within a foreign country.

The principles applied in sections 861 through 863 and section 865 and the regulations thereunder for determining the gross and the taxable income from sources within and without the United States shall generally be applied in determining the gross and the taxable income from sources within and without a particular foreign country when such a determination must be made under any provision of Subtitle A of the Internal Revenue Code, including section 952(a)(5). This section shall not apply, however, to the extent it is determined by applying § 1.863-3 that a portion of

the taxable income is from sources within the United States and the balance of the taxable income is from sources within a foreign country. In the application of this section, the name of the particular foreign country shall be used instead of the term *United States*, and the term *domestic* shall be construed to mean created or organized in such foreign country. In applying section 861 and the regulations thereunder for purposes of this section, references to sections 243 and 245 shall be excluded, and the exception in section 861(a)(3) shall not apply. In the case of any item of income, the income from sources within a foreign country shall not exceed the amount which, by applying any provision of sections 861 through 863 and section 865 and the regulations thereunder without reference to this section, is treated as income from sources without the United States. See § 1.937-2T for rules for determining income from sources within a possession of the United States.

[T.D. 9194, 70 FR 18928, Apr. 11, 2005]

#### § 1.863-7 Allocation of income attributable to certain notional principal contracts under section 863(a).

(a) *Scope—(1) Introduction.* This section provides rules relating to the source and, in certain cases, the character of notional principal contract income. However, this section does not apply to income from a section 988 transaction within the meaning of section 988 and the regulations thereunder, relating to the treatment of certain nonfunctional currency transactions. Further, this section does not apply to a dividend equivalent described in section 871(m) and the regulations thereunder. Notional principal contract income is income attributable to a notional principal contract as defined in § 1.446-3(c). An agreement between a taxpayer and a qualified business unit (as defined in section 989(a)) of the taxpayer, or among qualified business units of the same taxpayer, is not a notional principal contract, because a taxpayer cannot enter into a contract with itself.

(2) *Effective/applicability date.* This section applies to notional principal contract income includible in income on or after February 13, 1991. However,

any taxpayer desiring to apply paragraph (b)(2)(iv) of this section to notional principal contract income includible in income prior to February 13, 1991, in lieu of temporary Income Tax Regulations § 1.863-7T(b)(2)(iv) may (on a consistent basis) so choose. See paragraph (c) of this section for an election to apply the rules of this section to notional principal contract income includible in income before December 24, 1986. With respect to a dividend equivalent described in section 871(m) and the regulations thereunder, this section applies to payments made on or after January 23, 2012.

(b) *Source of notional principal contract income*—(1) *General rule.* Unless paragraph (b) (2) or (3) of this section applies, the source of notional principal contract income shall be determined by reference to the residence of the taxpayer as determined under section 988(a)(3)(B)(i).

(2) *Qualified business unit exception.* The source of notional principal contract income shall be determined by reference to the residence of a qualified business unit of a taxpayer if—

(i) The taxpayer's residence, determined under section 988(a)(3)(B)(i), is the United States;

(ii) The qualified business unit's residence, determined under section 988(a)(3)(B)(ii), is outside the United States;

(iii) The qualified business unit is engaged in the conduct of a trade or business where it is a resident as determined under section 988(a)(3)(B)(ii); and

(iv) The notional principal contract is properly reflected on the books of the qualified business unit. Whether a notional principal contract is properly reflected on the books of such qualified business unit is a question of fact. The degree of participation in the negotiation and acquisition of a notional principal contract shall be considered in this determination. Participation in connection with the negotiation or acquisition of a notional principal contract may be disregarded if the district director determines that a purpose for such participation was to affect the source of notional principal contract income.

(3) *Effectively connected notional principal contract income.* Notional principal

contract income that under principles similar to those set forth in § 1.864-4(c) arises from the conduct of a United States trade or business shall be sourced in the United States and such income shall be treated as effectively connected to the conduct of a United States trade or business for purposes of sections 871(b) and 882(a)(1).

(c) *Election*—(1) *Eligibility and effect.* A taxpayer described in paragraph (b)(2)(i) of this section may make an election to apply the rules of this section to all, but not part, of the taxpayer's income attributable to notional principal contracts for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. A taxpayer not described in paragraph (b)(2)(i) of this section that is engaged in trade or business within the United States may make an election to apply the rules of this section to all, but not part, of the taxpayer's income described in paragraph (b)(3) of this section for all taxable years (or portion thereof) beginning before December 24, 1986, for which the period of limitations for filing a claim for refund under section 6511(a) has not expired. If a taxpayer makes an election pursuant to this paragraph (c)(1) in the time and manner provided in paragraph (c) (2) and (3) of this section, then, with respect to such taxable years (or portion thereof), no tax shall be deducted or withheld under sections 1441 and 1442 with respect to payments made by the taxpayer pursuant to a notional principal contract the income attributable to which is subject to such election. The election may be revoked only with the consent of the Commissioner.

(2) *Time for making election.* The election specified in paragraph (c)(1) of this section shall be made by May 14, 1991.

(3) *Manner of making election.* The election described in paragraph (c)(1) of this section shall be made by attaching a statement to the tax return or an amended tax return for each taxable year beginning before December 24, 1986, in which the taxpayer accrued or received notional principal contract income. The statement shall—